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May 10, 1985

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Honorable John Vasconcellos, Chairperson
Assembly Ways and Means Committee

Honorable Alfred E. Alquist, Chairperson
Senate Committee on Budget and Fiscal Review

Gentlemen:

MAY REVISION REVENUE REPORT

The Department of Finance has completed the May Revision, and it is my responsibility to report our revised estimate of revenues available for the current year and the budget year. I am also submitting Governor Deukmejian's revised budget proposals.

The process of developing this year's forecast was significantly complicated by late and higher-than-average income tax payments. This trend differs markedly from the experience of the previous five years. Verifying the accuracy of this anomalous data, which didn't begin to appear until after April 15, required additional time in preparing this estimate. The tax amnesty program and the welcome strength of the California economy also had a significant impact on our ability to accurately project revenue.

Using the Governor's January budget as the point of reference, and after modification for Finance Letters previously sent to the Legislature, we estimate there could be as much as $614 million available for additional appropriations.

However, we now believe that it is prudent to reduce budget revenues for the loss associated with solar and energy tax credits. In January, we proposed a cap on these credits. We continue to stand by that proposal. Yet, we must take into account the fact that the Legislature has not finally acted on that proposal. Consequently, at this point in time, we can only count on an additional revenue of $433 million.

Before we consider new spending programs or tax reductions, the Governor and I believe that a state and society have a responsibility to meet its moral, as well as legal, obligations. The Governor came into office during a time of fiscal crisis. During that time, extraordinary actions were required to get the State back on a secure fiscal foundation. Among other things, special funds were borrowed and various obligations were incurred.

Our spending program proposes we continue to pay off these past debts before embarking upon new spending programs.

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Before we consider new spending programs or tax reductions, the Governor and I believe that a state and society have a responsibility to meet its moral, as well as legal, obligations. The Governor came into office during a time of fiscal crisis. During that time, extraordinary actions were required to get the State back on a secure fiscal foundation. Among other things, special funds were borrowed and various obligations were incurred.

Our spending program proposes we continue to pay off these past debts before embarking upon new spending programs.

The revised revenue estimates present us with a unique opportunity to clean up the backlog of obligations and further improve the soundness and fiscal stability of California. The Governor proposes that the additional $433 million revenues be appropriated as follows:

- **Education.** An additional $216 million for claims arising from the costs of desegregation activities and an additional $24 million for claims relating to the cost of home-to-school transportation for the special education program. This totals $240 million.

- **Local Government.** An additional $49 million for state mandated local programs; an augmentation of $22 million to replace property tax revenues anticipated but not received by special districts; an augmentation of $42 million as the first installment of a three-year payment schedule to reimburse local governments for the cost of their mandated unemployment insurance programs; and a repayment of $54 million to reimburse the emergency telephone account for monies redirected in previous years. This totals $167 million.

- **Other.** An augmentation of $11 million for an increase in local mental health community care rates; a repayment of $14 million to reimburse the offhighway vehicle fund for monies redirected in previous years; and an augmentation of $1 million for the Water Resources Control Board to locate toxic material discharge points with regard to drinking water systems. This totals $26 million.

By meeting these obligations and completing the task of returning to fiscal stability, we can continue to improve on the Governor's priority spending areas of education, public safety, job development, infrastructure and toxic waste cleanup. These areas already have received significant increases in resources in our January budget and we urge your approval of these improvements as well as the responsible measures we have presented in this letter.

I am available to discuss this report at your convenience.

Very truly yours,

JESSE R. HUFF
Director of Finance

Attachment

MAY REVISION

REVENUE REPORT AND

EXPENDITURE UPDATE

CONTENTS

	Page
General Fund Budget Update	1
The Economy	2-3
Economic Data (Table I)	4
Alternative National Forecasts	5
Alternative California Forecasts	6
Revenue Estimates	7-8
Revenue Estimates (Table)	9
Alternative Revenue Estimates	10
General Fund Expenditure Summary	11
General Fund Expenditure Detail	12

GENERAL FUND
BUDGET UPDATE
1984-85 and 1985-86
(Dollars in Millions)

	Amount 1984-85	1985-86
Prior Year Balance	$490.6	$1,041.8
REVENUES AND TRANSFERS:		
As of January 10, 1985	$26,076.9	$27,922.2
May Revision Adjustments 1/	459.0	107.0
Total Revenues and Transfers	$26,535.9	$28,029.2
EXPENDITURES		
As of May 6, 1985	$25,752.0	$27,958.5
Adjustments		
May 10 Report	227.6	65.3
Other Adjustments	$5.1 2/	-$1.8 3/
Total Adjustments	$232.7	$63.5
Total Expenditures	$25,984.7	$28,022.0
RESERVES	$1,041.8	$1,049.0
Carryover Appropriations	15.3	3.4
Economic Uncertainties	1,026.5	1,045.6 4/

1/ These adjustments include the Employment Development Department Contingent Fund transfers to the General Fund reported in the March 18, 1985 letter to the Legislature. The current estimates for these transfers are $10.1 million and $2.3 million for 1984-85 and 1985-86, respectively.
2/ The savings associated with the elimination of the Department of Corrections deficiencies were inadvertently counted twice ($8.8 million) and a deficiency for the Department of Health Services was duplicated (-$3.7 million).
3/ The accrual costs for a January, 1986, sale of Hazardous Substance Cleanup Bonds were erroneously carried as General Fund expenditures.
4/ Adjusted to maintain the reserve at 3.7 percent of revenues and transfers.

May 1985

THE ECONOMY

Overall, the national economic forecast underlying the revenue estimates has not changed significantly. It still appears that 1985 will see moderate growth to the end of the year. We believe that trend will continue through 1986, although the possibility of a downturn is greatly increased after the end of 1985.

There are several offsetting factors in the latest revision. Actual data for 1984 generally came in slightly lower than forecast. This alone would contribute to a higher growth rate for 1985 even if the forecast remained unchanged. On the other hand, economic reports indicate that the somewhat erratic pattern of the past year continues. We have assumed that the second quarter will see a strong rebound, and that the economy will experience moderate growth for the remainder of the year. There are some forecasters, however, who are predicting a growth recession from this point out. This is typical of the uncertainty which exists in the economy and, consequently, in the economics profession.

Real gross national product is now forecast at $1,694 billion for the current year, compared with $1,690 million used in developing the Governor's Budget. The percent change for the year is also slightly higher--3.3 percent as opposed to 3.0 percent.

California continues to outperform the Nation, although the current forecast is somewhat lower than that in the Budget. The most recent information indicates a slower rate of growth in wages and interest income, for instance. Table 1 summarizes changes in the economic forecast since the Budget was introduced.

Revenue collections have gained strength recently with a substantial surge in final payments being realized in the income taxes. Some of these gains represent unusual or one-time payments (such as amnesty), but they also are signaling changes in payment patterns or unanticipated gains from sources not measured in available economic data. To some extent, therefore, these current year revenue gains will also be carried forward into the budget year. The data from the Franchise Tax Board on income by source which will be available next year will be very useful in analyzing the specific causes for the stronger-than-expected receipts. Finally, there are still large amounts of revenue to come in this fiscal year: more than $5 billion. Substantial swings in collections can occur in May and June.

We have attempted to reconcile these various factors in our latest revenue estimates. Given the rapid change in economic trends, however, and the changes which are occurring in forecasts from one quarter to the next, it is still possible that future revisions may be significant.

We have also prepared alternative forecasts. The high side calls for a strong snap-back in the economy in the current quarter, and an above-average rate of growth through 1986. The low side sees a mild recession getting underway in the second half of 1985, with recovery starting before mid-1986. While it is possible that actual events may fall outside this range, we feel that we have encompassed the most likely developments for the next 18 months.

TABLE I
ECONOMIC DATA

	1985		1986	
	Budget	May Revision	Budget	May Revision
National data				
Real GNP: % change	3.0	3.3	3.3	3.0
GNP deflator: % change	4.0	4.0	4.3	3.7
Personal income: % change	7.5	6.9	7.4	6.7
Corporate profits: % change	2.0	0.3	15.1	6.2
CPI: % change	4.4	3.7	4.9	4.1
Housing starts: thousands	1695	1770	1800	1728
New car sales: millions	10.2	10.7	10.2	10.6
Wage & salary jobs: % change	2.6	3.2	2.0	1.9
Unemployment rate: %	7.2	7.0	6.6	6.6
California data				
Personal income: billions	$406.1	$399.7	$438.0	$428.3
Personal income: % change	8.6	7.7	7.9	7.2
Wages & salaries: % change	8.9	8.2	7.8	7.1
Housing units: thousands	185	205	195	195
Wage & salary jobs: % change	3.7	3.5	2.9	2.4
Unemployment rate: %	6.9	6.7	6.4	6.4
CPI: % change	4.9	4.5	4.9	4.4

ALTERNATIVE NATIONAL FORECASTS
May Revision 1985

		1985		
		High	Standard	Low
Real GNP	1985	1,701.4	1,693.9	1,677.7
% Change		3.8	3.3	2.3
	1986	1,776.5	1,744.6	1,677.1
		4.4	3.0	n.c.
Personal Income	1985	3,233.3	3,219.3	3,203.5
% Change		7.3	6.9	6.4
	1986	3,518.0	3,436.1	3,331.7
		8.8	6.7	4.0
Corporate Profits	1985	246.4	236.3	220.0
% Change		4.5	.3	-6.6
	1986	256.9	250.9	217.5
		4.2	6.2	-1.1
Housing Starts	1985	1,875	1,770	1,685
	1986	1,955	1,728	1,536
New Car Sales	1985	10.9	10.7	10.1
	1986	11.2	10.6	9.6
Nonagricultural Employment	1985	97,397	97,163	96,746
% Change		3.5	3.2	.9
	1986	100,327	99,013	96,537
		3.0	1.9	-0.2
Unemployment Rate	1985	6.9	7.0	7.3
	1986	5.8	6.6	8.2
CPI: % Change	1985	4.0	3.7	3.6
	1986	5.1	4.1	3.4

ALTERNATIVE CALIFORNIA FORECASTS

	1985			1986		
	High	Standard	Low	High	Standard	Low
Personal income						
May Revision	401.5	399.7	397.1	438.6	428.3	414.9
% change	8.2	7.7	7.0	9.3	7.2	4.5
Budget	409.8	406.1	396.7	450.2	438.0	409.4
% change	9.6	8.6	6.1	9.8	7.9	3.2
Nonagricultural Employment						
May Revision	10,987	10,950	10,887	11,423	11,216	10,862
% change	3.9	3.5	2.9	4.0	2.4	-0.2
Budget	11,121	11,016	10,796	11,610	11,330	10,628
% change	4.7	3.7	1.7	4.4	2.9	-1.6
Unemployment rate						
May Revision	6.6	6.7	7.0	5.4	6.4	8.1
Budget	6.4	6.9	8.1	5.6	6.4	9.9
Housing units						
May Revision	225	205	188	230	195	181
Budget	215	185	153	226	195	169

REVENUE ESTIMATES

Overview

General Fund revenues and transfers for 1984-85 are expected to total $26,536 million, or $459 million above the Budget estimate. For Fiscal Year 1985-86, the total estimated revenues and transfers are $28,029 million, up $107 million from the amount shown in the Governor's Budget.

The revenue estimates for Motor Vehicle Fuel and Use Fuel Taxes and for Vehicle License Fees are not being revised at this time. Preliminiary cash data indicate that these revenues are tracking well with the Budget estimates. A full analysis and update will be done for the August report.

Based on our discussion with the interim staff at the State Lottery Commission, we see no reason to change the $300 million revenue estimate presented in the 1985-86 Budget. The Commission plans to start up an instant game in September. Until that time, we have no experience or data on which to base a revised estimate of California State Lottery revenues.

Sales and Use Tax		
	1984-85	-$55 million
	1985-86	-$30 million

General Fund revenues for 1984-85 and 1985-86 combined are expected to be $85 million below the Budget estimate. This revision includes a gain of $31 million from tax amnesty.

To date, $29 million in sales tax revenue has been collected from the sales tax amnesty program. An additional $12 million in reported liability is expected to be received over the next year, bringing the net revenue gain to $41 million, compared with the budget estimate of $10 million. Excluding amnesty, revenues are estimated to be down $76 million during 1984-85 and down $40 million during 1985-86 due to economic factors.

Personal Income Tax		
	1984-85	+$355 million
	1985-86	-$40 million

The increase in estimated personal income tax revenues is due primarily to a tremendous surge in final payment receipts during April. Since refunds appear to be in line with the Budget forecast, this indicates that 1984 liabilities substantially exceeded expectations. Although a portion of this appears to be a one-time gain, the May forecast assumes that some of this higher liability level will carry forward into the budget year. The budget year also includes a reduction of $235 million reflecting the tax loss associated with funding the solar and energy tax credits.

It appears that the personal income tax amnesty program was more successful than expected in encouraging delinquent taxpayers to pay prior, unpaid liabilities. Since all of the amnesty returns have not yet been processed and taxpayers are permitted to pay their liabilities in installments, the revenue effects of amnesty are still estimates. However, the May Revision incudes an additional $22 million over the current and budget years for this program.

Bank and Corporation Tax

1984-85 +$175 million
1985-86 +$85 million

Bank and corporation tax revenues are estimated to be up $175 million in the current year and $85 million in the budget year. This increase is primarily due to recent cash flow experience and historical statistical data not available at the time of the budget forecast. The budget year also includes a reduction of $15 million reflecting the tax loss associated with funding the Solar and Energy Tax Credit.

Other Revenues

1984-85 +$65 million
1985-86 +$89 million

There are various changes in the other revenues, but it should be noted that the General Fund's share of Pooled Money Investment balances has substantially exceeded the Budget forecast. Thus, although the yield is slightly below expectations, total interest income for the current and budget years should be up $30 million and $70 million, respectively.

Transfers

1984-85 -$81 million
1985-86 +$3 million

The Governor's Budget had proposed to initiate a repayment program for funds previously transferred from the Emergency Telephone 911 Account and from the Off Highway Vehicle (OHV) Fund. It is now proposed that these repayments be made entirely effective in June during the current year and the following charges are reflected in the transfers. This will be accomplished by adding two new control sections to the Budget.

	911	OHV	IMPACT
1984-85	-$68.8	-$21.5	-$90.3
1985-86	14.5	7.0	21.5
Net	-$54.3	-$14.5	-$68.8

GENERAL FUND REVENUE ESTIMATES
(In millions)

	Budget Estimate	May Revision	Difference From Budget Estimate
		1984-85	
Source			
Sales Tax	$9,705	$9,650	-$55
Personal Income Tax	10,485	10,840	+355
Bank & Corporation Tax	3,525	3,700	+175
Other Revenues	2,334	2,399	+65
Transfers	28	-53	-81
Total	$26,077	$26,536	+$459
		1985-86	
Sales Tax	$10,510	$10,480	-$30
Personal Income Tax	11,165	11,125	-40
Bank and Corporation Tax	3,950	4,035	+85
Other Revenues	2,275	2,364	+89
Transfers	22	25	+3
Total	$27,922	$28,029	+$107
Change from 1984-85	+$1,845	+$1,493	
Percent	7.1	5.6	

ALTERNATIVE REVENUE ESTIMATES

General Fund revenue in 1985-86 could be almost $1.1 billion below the budget estimate if the economic growth underlying the revenue estimates does not materialize. However, a more robust economy than forecast could lead to revenues of approximately $800 million above the estimates.

The following table compares the 1984-85 and 1985-86 General Fund revenue estimates with high and low alternative estimates.

	(In millions)		
	High Alternative	Budget Estimate	Low Alternative
1984-85	$26,625	$26,536	$26,430
1985-86	$28,800	$28,029	$26,900

GENERAL FUND
EXPENDITURE SUMMARY
(Dollars in Millions)

	1984-85	1985-86
Department of Education (K-12)	$169.4	$71.4
Water Resources Control Board	--	1.0
Department of Mental Health	--	11.3
Special Supplemental Subventions for Non-Enterprise Special Districts	21.8	--
Tax Relief	--	-68.5
State Mandated Local Programs	16.4	75.1
Unidentified Savings	20.0	-25.0
Totals, Expenditure Adjustments	$227.6	$65.3

GENERAL FUND
EXPENDITURE DETAIL
1984-85 AND 1985-86
(Dollars in Millions)

RESOURCES

State Water Resources Control Board--Toxics in Drinking Water	1984-85	--
	1985-86	$1.0
		(18 PY)

For the past two years we have funded at an increasing level in the Department of Health Services activities to assess and identify potential toxic substances in drinking water systems. Evidence is accumulating which suggests that this is a fairly wide-spread problem. The Legislature's toxic task force identified the need to augment the Water Resources Control Board to enable them to find the discharge points for these toxic materials. Therefore it is requested that 19 positions (18 personnel years) be added to allow the Board to begin addressing this problem.

HEALTH AND WELFARE

Department of Mental Health--Community Care Rates	1984-85	--
	1985-86	$11.3

The Department of Mental Health is required by statute to establish rates and annually propose such rates to the Legislature. Current year Budget Bill language requires a report reviewing the adequacy of the rates paid to community care providers for mental health clients. This report has been done and is being forwarded to the Legislature. It identifies a need of some $11.3 million to adjust various rates so that they are adequate. The major emphasis is to attract residential care providers not providing services because of the inadequate rates.

EDUCATION

Department of Education--K-12 Desegregation Funding	1984-85	$145.0
	1985-86	71.4

Unfunded 1983-84 and 1984-85 desegregation claims total about $145 million. 1985-86 claims are expected to be about $71 million more than currently is appropriated in the Budget Bill. The Board of Control claims bill (AB 38) currently contains an appropriation of $5.5 million to pay for unfunded 1983-84 and 1984-85 desegregation claims. The Administration recommends that the appropriation in AB 38 be increased by $139.5 million to fund all 1983-84 and 1984-85 unfunded claims. We also recommend that the Budget Bill appropriations for court-ordered and voluntary desegregation costs be increased by $10.4 million and $61 million.

Department of Education--Home-to-School Transportation Deficiency	1984-85	$24.4

The 1984-85 appropriation for home-to-school transportation is $24.4 million less than is required to pay all district and county office claims under current law. The Administration recommends that this deficiency be funded and therefore supports the appropriation of $24,400,000 currently contained in AB 1304.

GENERAL GOVERNMENT

Tax Relief--Alternative Energy Tax Credits	1984-85	--
	1985-86	-$68.5

The 1985-86 Budget (Item 9100-101-001(h)) proposed to appropriate $68.5 million to fund Alternative Energy Tax Credits. This was intended to be a 50 percent reduction in the level of 1985-86 tax credits allowed. However, revised estimates of 1985-86 claims are now higher than originally anticipated. This proposal was rejected by the Legislature, although one subcommittee has reopened the item and changed the appropriation to $125 million (50% of the current estimate for claims).

The Legislative Analyst has argued that legislation is required to limit the credits claimed. We still believe limiting the credits can be accomplished through the Budget Bill and continue to stand by our proposal. Yet, we must take into account the fact that the Legislature has not finally acted on that proposal. Consequently, we are requesting that the appropriation be eliminated and are, therefore, withdrawing the proposed appropriation. The impact of this change is a net reduction of $182 million in available resources.

Local Government Financing--Special Supplemental Subventions For Non-Enterprise Special Districts	1984-85	$21.8
	1985-86	-0-

Chapter 447, Statutes of 1984, established a $10 million one-time appropriation to be allocated by the State Controller in the event Supplemental Roll tax revenues fell short of the amount these districts had previously received in Business Inventory Exemption (BIE) subventions. At the time this appropriation was established, it was estimated that total claims (based on BIE subventions) would be $24 million, but supplemental revenues would be $25 million. The $10 million was a contingency in the event that supplemental roll revenues decreased or claims increased. It now appears that claims will total $31.8 million and no supplemental roll revenues will be received by these special districts in 1984-85. In order to keep with the "New Partnership" spirit to help local governments transition from BIE subventions, an additional $21.8 million is needed. It is proposed that this amount be included in the omnibus deficiency bill for the 1984-85 fiscal year.

State Mandated Local Programs--Eliminate AFDC-BHI Offset	1984-85	$16.4
	1985-86	33.1

Current year expenditures are expected to increase by $30.1 million over the amounts available to pay claims filed with and desk-audited by the State Controller. This amount reflects deficiencies of $10.8 million in 1984-85 appropriations, $19.1 million in 1983-84 appropriations and $.2 million in 1982-83 appropriations. Provisions Nos. 11 and 12 in Item 9680 allow the Controller to pay prior year claims from the 1984 Budget Act appropriation and, if that causes the appropriation to be inadequate to pay current year claims, to notify the Legislature and, 30 days thereafter, the appropriation is increased by the amount of the excess. These provisions were added for the first time in the 1984 Budget Act and it is planned that such a notification will be given to increase Item 9680 by $30.1 million rather than to request that amount in the deficiency bill.

Budget year expenditures are expected to increase by $11.8 million over the amounts budgeted in Item 9680. This estimate is based on the fact that local entities have filed, and the Controller desk-audited, claims for costs to be incurred in 1984-85 which exceed the 1984 Budget Act by that amount. Since the amounts requested in the 1985-86 Governor's Budget are at essentially the same level as 1984-85, it would appear reasonable to assume that the expenditures by local entities and therefore the increase needed in the amount budgeted will be approximately the same.

To summarize:

	May 6	May 10	Difference
1984-85	$13.7	$30.1	$16.4
1985-86	-21.3	11.8	33.1

State Mandated Local Programs--Unemployment Insurance

1984-85	--
1985-86	$42.0

Consistent with the State Supreme Court's ruling that the costs to local government for providing unemployment insurance benefits to their employees, as required by Chapter 2, Statutes of 1978, are a state-mandated local program, we are proposing to reimburse those costs which have been incurred from 1977-78 through 1984-85. Those costs are estimated to be as follows:

Counties	$70.0
Cities	35.0
Special Districts:	
Tax-supported	12.0
Fee-supported	(17.0)
Undetermined	9.0
Totals	$126.0

We propose to sponsor legislation which would appropriate $42 million in each of the 1985-86, 1986-87 and 1987-88 fiscal years for a total of $126 million.

Unidentified Savings

1984-85	$20.0
1985-86	-25.0

The Governor's Budget estimated unidentified savings to be $60 million in 1984-85 and $125 million in 1985-86. In the May 6 letter, we recognized savings in various departments which would normally be included in unidentified savings. We are therefore reducing our current year estimate of unidentified savings by $20 million. In the May Revision expenditure proposals for 1985-86, we have anticipated expenditures which could have limited actual savings in the budget year. Since we are proposing to fund such costs, our estimate of savings is increased by $25 million to $150 million.